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MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1972

No. 72-5[illegible]2

CITIES SERVICE OIL COMPANY, SUCCESSOR BY MERGER TO COLUMBIAN FUEL COMPANY,

Petitioner,

v.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Cities Service Oil Company, Successor By Merger To Columbian Fuel Company, prays that a writ of certiorari issue to review the decision of the United States Court of Claims granting respondent's motion for summary judgment and denying petitioner's motion for summary judgment.

Opinion Below

The opinion of the Court below is reported at 462 F. 2d 1134, and set forth in the Appendix, *infra*, p. 17.

Jurisdiction

The decision of the Court below having been entered on July 14, 1972, the jurisdiction of this Court is invoked under 28 U.S.C. § 1255(1).

Questions Presented

1. Whether this Court's decision in *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969), rehearing denied 395 U.S. 941 (1969), involving the interpretation of Section 1341(a)(4) of the Internal Revenue Code of 1954, is determinative in the instant case where the taxpayer is required to compute its tax under Section 1341(a)(5) of the 1954 Internal Revenue Code.

2. If not, whether Section 1341(a)(5) of the 1954 Internal Revenue Code requires that a taxpayer which produced and sold natural gas, and included the sales proceeds therefrom in "gross income" as well as "gross income from the property" for computing percentage depletion, must retroactively reduce its otherwise allowable depletion deductions for the years of receipt because in a subsequent taxable year it was required to restore a portion of the sales price to the purchasers of such natural gas.

3. Alternatively, whether this Court should reconsider its decision in *Skelly Oil*, *supra*, in light of its application by lower courts in proceedings clearly not expected by this Court, as well as the failure of the Commissioner of Internal Revenue to promulgate proposed Treasury Regulation § 1.613-2(c)(8), the equity of which respondent urged upon this Court, and the adoption of which was contemplated by this Court in that case.

Statutes and Regulations

Sections 611, 613 and 1341 of the 1954 Internal Revenue Code, and pertinent parts of Sections 1.61-3, 1.62-1, 1.613-3, and 1.1341-1 of the Treasury Regulations on Income Tax (1954 Internal Revenue Code) are set forth in the Appendix, *infra*, pp. 26-32.

Statement

Petitioner, successor by merger to Columbian Fuel Company (Columbian), brought this suit for refund of 1959 Federal income tax. During the taxable years 1949 through 1958, Columbian, a producer-seller of natural gas, included in its "gross income" the sum of $1,345,000 received by it from natural gas sales, because it appeared that Columbian had an unrestricted right to such monies. In addition, Columbian included such amount in its "gross income from the property" during such years in determining its percentage depletion allowance, deducting 27½ percent thereof from its "gross income" to arrive at its "taxable income," which deduction was allowed by the Commissioner of Internal Revenue (Commissioner) for the 1949 to 1958 taxable years.

During the taxable year 1959, Columbian, under threat of litigation, refunded the entire $1,345,000 to Panhandle Eastern Pipe Line Company and Colorado Interstate Gas Company. On its return for 1959 Columbian deducted the entire amount of the refund. However, on audit, Columbian maintained it was entitled to the benefits of Section 1341 of the 1954 Internal Revenue Code. The Commissioner agreed, and determined Columbian's tax liability for the taxable year under Section 1341(a)(5) of the Code, inasmuch as that computation produced a lesser tax for 1959 than would a Section 1341(a)(4) computation.

In determining Columbian's tax liability for 1959 under Section 1341(a)(5), the Commissioner reduced Columbian's *net taxable income* for the prior taxable years by 72½ percent of the amount refunded with respect to each such prior taxable year; i.e. the amount refunded with respect to each such year was first reduced by 27½ percent, the percentage depletion deduction which previously had been properly claimed and allowed with respect thereto, the net amount of such refund thereafter being excluded from Columbian's *net taxable income*.

The deficiency for the taxable year 1959 was paid, and a timely claim for refund filed, which claim was disallowed. The instant suit for refund was then commenced in the United States Court of Claims.

In dismissing petitioner's suit, the Court of Claims held that the facts in this case were indistinguishable from the facts presented in *Skelly Oil, supra*. Although in the instant case Section 1341(a)(5) of the Code is controlling, whereas in *Skelly* the applicable statutory provision was Section 1341(a)(4), the lower Court held that this Court would have reached the same result in *Skelly* had Section 1341(a)(5) been applicable in that case.

Reasons for Granting the Writ

1. The decision of the Court of Claims is based solely on a decision of this Court which is not determinative of the issue in this proceeding.

There can be no dispute that the Court below predicated its entire holding on this Court's decision in the *Skelly* case. In answer to petitioner's argument that *Skelly*, which involved Section 1341(a)(4) of the Internal Revenue Code, was not precedent in a proceeding involving a claim under Section 1341(a)(5), the Court of Claims stated (Appendix, p. 24, *infra*):

> We do not agree. Our reading of *Skelly* leads to the conclusion that the Supreme Court would have

> reached the same result if Section 1341(a)(5) had applied in that case.

For the reasons set forth below, petitioner submits that the Court below was in error.

This Court in *Skelly* clearly limited its holding to cases involving Section 1341(a)(4). This is evident from the statement, at 394 U.S. 682:

> In this case, the parties have stipulated that § 1341(a)(5) does not apply. Accordingly, as the courts below recognized, respondent's taxes must be computed under § 1341(a)(4) and thus, in effect, *without regard to the special relief Congress provided through the enactment of § 1341.* (Emphasis supplied)

Moreover, analysis of *Skelly* establishes the focal point of that decision to have been the relationship between the term "item" as it appears in subsections (a)(1) and (a)(2) of the statute, and the term "deduction" as it appears in subsections (a)(2) and (a)(4) of the statute. Reasoning that the (a)(4) term "deduction" refers to the "deduction" mentioned in subsection (a)(2), the Court concluded that the former could not be mechanically equated to the "item" referred to in subsection (a)(1), and that it was free to define judicially the nature and scope of the "deduction" referred to in subsection (a)(4).

It is clear from the Congressional mandate set forth in Section 1341(a)(5) that the latitude to define judicially the operative statutory expression[1] seized upon in *Skelly* is not available in this proceeding.

As enacted, the statute provides that if an *item* was included in gross income for prior taxable years (1949-1958) under a claim of right (subsection (a)(1)); and a deduction is allowable for the taxable year (1959) because

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[1] Or, as noted by Mr. Justice Douglas in his dissent, to put the "gloss on the statute that Treasury desires." 394 U.S. 689.

it subsequently was established that the taxpayer did not have an unrestricted right to *such item* (subsection (a)(2)); and such deduction exceeds $3,000, then the tax for the taxable year (1959) is the lesser of (subsection (a)(3)):

1. the tax for the taxable year computed with such deduction (subsection (a)(4)-*Skelly*); or

2. the tax for the taxable year without such deduction (subsection (a)(5)(A)), minus the decrease in tax for the prior taxable years (1949-1958) which would result solely from the exclusion of such *item* from gross income for such prior taxable years (subsection (a)(5)(B)).

Thus, while this Court in *Skelly* was presented with the question as to whether the (a)(4) "deduction" was equatable to the (a)(1) "item," the case at bar presents the question as to whether the (a)(5)(B) "item" was intended by Congress to be identical to the (a)(1) "item." In this regard, the Court below ignored the holding in *Skelly* that the (a)(1) "item" is "the item included in gross income in the year of receipt." 394 U.S. 683.

Petitioner submits that the Congress also has eliminated any possible ambiguity in an (a)(5) proceeding by using the words "item" in subsection (a)(1), and "*such* item" in subsection (a)(5)(B), thereby establishing beyond any doubt that the terms are identical. Thus, in the instant case, the "item" originally included in gross income ($1,345,000) is the "item" which should have been excluded therefrom, and not 72½ percent of the "item."

Further evidence of the inapplicability of *Skelly* to the instant case is to be found in this Court's statement, at 394 U.S. 682, that:

> Nevertheless, it is clear that Congress did not intend to tamper with the underlying claim-of-right doctrine; it only provided an alternative for certain

> cases in which the *new approach* • • • [subsection (a)(5)] • • • favored the taxpayer. When the new approach was not advantageous to the taxpayer, *the old law was to apply under § 1341(a)(4).* (Emphasis supplied)

Thereafter, this Court focused its attention on the "old law" as it saw it to be codified in subsection (a)(4). Thus, the reliance on *Skelly* by the Court below as controlling in a case admittedly involving the "new approach" is totally in error.

Finally, the instant proceeding, unlike *Skelly*, does not involve the "double deduction" which this Court found in *Skelly*. The only deduction here (percentage depletion) was, as the parties agree, properly claimed and allowed in the prior taxable years. Section 1341(a)(5)(B) mandates that the restored "item" be excluded, not deducted, from "gross income." Even if this exclusion be construed as the practical equivalent of a double deduction, it is pursuant to "a clear declaration of intent by Congress." See 394 U.S. 684.

In light of the foregoing, petitioner respectfully submits that *Skelly* has no precedential value in this proceeding.

2. The holding of the Court below is contrary to the clear and unambiguous mandate of the Congress set forth in Section 1341(a)(5).

As the Court below found, petitioner has met all the requirements necessary to the application of 1341(a)(5). The entire $1,345,000 was included by it in gross income in the years received under a claim of right (subsection (a)(1)). A deduction was allowable in the year of restoration because it was established that petitioner did not have an unrestricted right to any portion of the $1,345,000 (subsection (a)(2)). The deduction exceeded $3,000 (subsection (a)(3)). And finally, an (a)(5) computation produces a lesser tax than an (a)(4) deduction.

At this point, however, the lower Court parts company with the statute. In describing the action of the Com-

missioner which it affirmed, the Court of Claims stated, Appendix, *infra*, p. 19:

> In computing the tax for the reopened prior years, the Service excluded the amounts the taxpayer collected during these years and repaid in 1959. However, *the exclusions were reduced by the amount of the depletion deductions the taxpayer had been allowed during each of the prior years.* (Emphasis supplied)

While this may comport with the manner in which the lower Court would have written subsection (a)(5)(B), it is diametrically opposite to the manner in which (a)(5)(B) was written by the Congress. Congress mandated that the decrease in tax for the prior taxable years (1949-1958) under subsection (a)(5)(B) was that decrease "which would result solely from the *exclusion of such item* *** *from gross income* for such prior taxable year (or years)."

Since both the Congress, and this Court in *Skelly*, make it clear that the (a)(5)(B) "item" is identical to the (a)(1) "item," the Commissioner and the lower Court were in error in excluding from gross income in the prior taxable years anything less than $1,345,000.

In its Brief below respondent explained the Commissioner's adjustment in this proceeding. (Appendix, *infra*, p. 37.) Analysis of this explanation indicates that the Court below concluded that one of the following alternative adjustments was required under Section 1341(a)(5)(B):

(1) The item to be excluded from gross income for the prior years must be reduced by 27½ percent;

(2) Net taxable income for the prior taxable years must be reduced by 72½ percent of the refunded item;

(3) The tax for the prior taxable years must be reduced by the tax on 72½ percent of the refunded item; or

(4) The depletion allowance attributable to the refunded item must be eliminated.

In the construction of statutes, words having a fixed legal meaning are presumed to have been used in that sense. *Real Estate Title Co.* v. *United States,* 309 U.S. 73 (1940). Application of this basic principle in the instant proceeding clearly evidences the errors committed by respondent, and the Court below, in their construction of Section 1341(a)(5).

"Gross Income" is carefully defined in Treasury Regulations § 1.61-3(a) (Appendix, *infra,* p. 29) as "the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. *Gross income is determined without subtraction of depletion allowances based on a percentage of income,* * * *." (Emphasis supplied) Thus, the mandate of the Congress in subsection (a)(5)(B) of Section 1341 can only mean that the entire item originally included in "gross income" during the prior taxable years must now be excluded therefrom; i.e. $1,345,000, and not only 72½ percent of that amount. Accordingly, adjustment (1), *supra,* is precluded by the statute.

Similarly, adjustments (2) and (3) must be struck down. The statute does not refer to "net taxable income," nor does it speak of "the tax on 72½ percent of the refunded amount."

And finally, by what authority can petitioner's percentage depletion allowances for the taxable years 1949 to 1958 be retroactively eliminated in computing its tax for 1959? Certainly, if the annual accounting concept still has any viability,[2] it cannot be construed so as to permit the retroactive elimination, in otherwise closed prior taxable years, of deductions properly claimed and properly allowed when claimed.

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[2] See 20 *Tulane Tax Institute* 407-408 (1971).

Sections 611 and 613 of the 1954 Code fix petitioner's percentage depletion allowance for the taxable years 1949 to 1958 at 27½ percent of its "gross income from the property," but not in excess of 50 percent of its "taxable income from the property."

By definition, "gross income from the property," in the case of oil and gas wells, is that amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well (gross receipts). Treasury Regulations § 1.613-3(a), Appendix, *infra*, p. 30. To arrive at "gross income," gross receipts (gross income from the property) must be reduced by the cost of goods sold, which, in the case of oil and gas wells, is comprised of lifting costs. Revenue Ruling 60-344, 1960-2 C.B. 186, cited with approval in *Laguna Royalty Co.*, T.C. Memo. 1968-36, 27 TCM 164, *aff'd*, 406 F.2d 703 (C.A. 5, 1969).[3]

A similar distinction exists between "taxable income" and "taxable income from the property." "Taxable income" is defined as "gross income, minus the deductions allowed by this chapter, * * *" (Section 63, 1954 Code), one such deduction being percentage depletion. On the other hand, "taxable income from the property" is defined as "gross income from the property * * * less allowable deductions (excluding any deduction for depletion) which are attributable to the mineral property * * *." Treasury Regulations § 1.613-4(a).

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[3] The requirement that lifting costs must be subtracted from "gross receipts" (gross income from the property) to arrive at "gross income" clearly evidences the distinction in the revenue laws between "gross income from the property" and "gross income." See analogous result in Reventue Ruling 67-169, 1967-1 C.B. 159; see also *Murphy Oil Corporation* v. *United States*, 337 F.2d 677 (C.A. 8, 1964), *aff'g* 230 F. Supp. 583.

The following example illustrates the operation of these precise legal terms:

Gross income from the property (Gross receipts)	$ 100,000	
Less:		
Lifting costs	8,000	
Gross income		$ 92,000
Less:		
Percentage depletion (27½% of Gross income from the property)	27,500	
Other deductions	7,500	35,000
Taxable income		$ 57,000

If the entire $7,500 of other deductions was attributable to the mineral property then "taxable income from the property" would be $84,500 ($100,000—$15,500)

Section 1341(a)(5), the only statutory provision at issue in this proceeding,[4] calls for the exclusion of the restored item from petitioner's "gross income," not its "gross income from the property," nor its "taxable income from the property," nor its "taxable income." In light of the statutory and regulatory definitions set forth above, respondent certainly cannot contend that these terms have identical meanings. And yet that is exactly the position which it took before the Court below.

Accordingly, petitioner submits that the Commissioner's elimination of petitioner's percentage depletion deductions

[4] There is nothing in either Section 611 or Section 613 which permits the retroactive elimination of petitioner's properly claimed and allowed percentage depletion deductions for the prior taxable years.

(adjustment 4, *supra*) finds no support in either the statute or the regulations, violates the annual accounting concept, and, therefore, must be reversed.

In approving the action of the Commissioner, the Court below concluded that Treasury Regulations § 1.1341-1(d)(4)(ii) (Appendix, *infra*, p. 41), which calls for an adjustment to previously claimed depletion deductions under subsection (a)(5), was consistent with this Court's holding in *Skelly*. In reaching this conclusion the lower Court did not pass upon petitioner's argument that the cited Regulation was invalid in light of the clear and unambiguous language of the statute, and, if applicable, the Legislative History accompanying the enactment of Section 1341.

The inapplicability of *Skelly* in this proceeding has been discussed above. Thus, petitioner submits that the Court below was in error when it failed to answer petitioner's arguments as to the invalidity of the cited Regulation.

The statute permits only one adjustment in prior years, and that is to determine the decrease in tax attributable *solely to* the removal of the item restored from gross income for such prior years. There is nothing ambiguous in the statutory language, and thus reference to the Legislative History is not warranted. However, in light of the fact that the Legislative History permits only those adjustments predicated upon "adjusted gross income"[5] or "taxable income,"[6] neither of which is the basis for per-

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[5] Only applicable to limit deductions in the case of individuals, Treasury Regulations § 1.62-1(a), Appendix, *infra*, p. 29.

[6] In the case of corporations only limits: (1) contributions, Code Section 170(b)(2); (2) the net operating loss, Code Section 172; (3) dividends received deductions, Code Section 246(b)(1); (4) dividends paid on public utility preferred stock, Code Section 247; (5) Western Hemisphere Trade Corporation deductions, Code Section 922; and (6) foreign tax credit, Code Section 904.

centage depletion, it is obvious that this expression of Congressional intent does not support, either the cited Regulation, the action of the Commissioner, or of the Court below. See 68 Dickinson Law Review pp. 395-400 (1964).

Wherefore, petitioner submits that the holding of the Court below is contrary to the clear and unambiguous mandate of the Congress as set forth in Section 1341(a)(5), and must be reversed.

3. The orderly administration of the revenue statutes, as well as the rate-making authority of the Federal Power Commission, requires that the instant writ be granted so as to remove existing uncertainty with respect to restorations of claim-of-right items under Section 1341(a)(5).

While petitioner is not privy to either the latest annual statistics of corporate income and deductions, or the tabulations dealing with Federal Power Commission rate-making proceedings, it believes that the question herein raised is of sufficient importance to warrant the granting by this Court of the instant writ of certiorari. If, as argued by the government in *Skelly*,[7] the issue was of such magnitude to convince this Court that certiorari should be granted, the same should hold true in the instant case.

Moreover, there exists a clear conflict between the holding of the Court below that *Skelly* is controlling herein, and the holding of this Court in *Skelly* that that case was not concerned with "the special relief Congress provided through the enactment of § 1341." 394 U.S. 682.

4. Alternatively, subsequent events have transpired which substantially affect this Court's holding in *Skelly*, and which warrant reconsideration of that case.

In reaching its conclusions, this Court in *Skelly* stated that "the approach here adopted will affect only a few

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[7] Petition for Certiorari to the United States Court of Appeals for the Tenth Circuit, pp. 16-19, *Law Reprints Tax Series*, Vol. 1, No. 5, 1968-1969 Term.

cases," 394 U.S. 686, thereafter discussing the allowance for percentage depletion. Apparently it was believed that *Skelly,* by this language, was limited only to proceedings involving percentage depletion and Section 1341(a)(4).

Notwithstanding this limiting language, to date there have been at least six proceedings not involving percentage depletion wherein *Skelly* has been cited precisely the way this Court said it would not be.

In *Mitchell* v. *C.I.R.,* 428 F.2d 259 (C.A. 6, 1960), *rev'g* 52 T.C. 170 (1969), the Sixth Circuit applied *Skelly* in a case involving the restoration of insider profits. Apparently, the Tax Court was not impressed with the *Skelly* result alluded to by the Sixth Circuit in *Mitchell,* because in a subsequent proceeding, *James E. Anderson,* 56 T.C. 1370 (1971), a majority of that Court refused to adopt the conclusion of the Sixth Circuit. Nevertheless, the minority in *Anderson* continued to persist in the *Skelly* approach. This case is presently on Appeal by the government to the Seventh Circuit.

A minority of the United States Court of Claims in *Missouri Pacific Railroad Company* v. *United States,* 423 F.2d 727 (Ct. Cl., 1970) at page 736, would have decided that proceeding adversely to the taxpayer because of what it considered to be the broad central theme of *Skelly. Missouri Pacific* involved railroad freight cutbacks, and not percentage depletion.

In *Morris Bloomfield,* 52 T.C. 745, 747 (1969), *Skelly* was cited as support for the "tax benefit" doctrine. As in *Mitchell, Anderson,* and *Missouri Pacific,* percentage depletion was not involved in *Bloomfield.* A similar citation of *Skelly* can be found in *Intervest Enterprises, Inc.,* T.C. Memo. 1971-245, 30 TCM 1057 at page 1063, again a nondepletion case.

In *Dynamics Corporation of America* v. *United States,* 449 F.2d 402 (Ct. Cl., 1971), another of the so-called "tax benefit" cases not involving percentage depletion *Skelly*

was cited to limit a deduction claimed during the taxable year for amounts paid in settlement of a stockholders' derivative suit.

Petitioner respectfully suggests that these cases clearly evidence the "major transformation of the deduction which has heretofore been allowed and which Congress recognized in § 1341(a)(4)" to which Mr. Justice Stewart alluded in his dissent in *Skelly* (394 U.S. 697), notwithstanding this Court's attempt to limit the application of its holding.

Moreover, despite the fact that *Skelly* was concerned with a "relief" statute, the application of that decision by the courts below has created a situation where it appears that the government always wins and the taxpayer always loses. See 394 U.S. 686.

In addition to the foregoing, this Court in *Skelly* relied upon the representation that:

> the Commissioner has indicated that the Government will only seek to reduce the deduction in the year of repayment to the extent that the depletion allowance attributable to the receipt directly or indirectly reduced taxable income. Proposed Treas. Reg. § 1.613-2(c)(8), 33 Fed. Reg. 10702-10703 (1968). 394 U.S. 689, footnote 5.

This expression of Administrative intent, it was reasoned, would insure the sanctity of the annual accounting concept; preclude the opening of prior returns; and insure that no attempt would be made to require that the tax savings from the deduction equal the tax consequences of the receipt in prior years.[8]

However, despite the fact that this Regulation was proposed on July 26, 1968, it has not been finalized to date. In fact, it no longer appears in Proposed form, and apparently has been withdrawn.

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[8] But see 20 *Tulane Tax Institute* 418-419.

In light of this fact, petitioner respectfully suggests that reconsideration of *Skelly*, by this Court, would appear to be warranted.

CONCLUSION

WHEREFORE, it is prayed that, for the foregoing reasons, this petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

Opinion of Court of Claims

IN THE UNITED STATES COURT OF CLAIMS

No. 290-68

(Decided July 14, 1972)

CITIES SERVICE OIL COMPANY, SUCCESSOR BY MERGER TO COLUMBIAN FUEL COMPANY v. THE UNITED STATES

ROBERT J. CASEY, attorney of record, for plaintiff. THOMAS E. TYRE, JOHN A. CRAIG, and CASEY, TYRE, WALLACE & BANNERMAN, of counsel.

DAVID J. GULLEN, with whom was ASSISTANT ATTORNEY GENERAL SCOTT P. CRAMPTON, for defendant. PHILLIP R. MILLER and JOSEPH KOVNER, of counsel.

Before COWEN, CHIEF JUDGE, LARAMORE, SENIOR JUDGE, DAVIS, SKELTON, NICHOLS, KASHIWA, and KUNZIG, JUDGES.

ON DEFENDANT'S AND PLAINTIFF'S MOTIONS FOR SUMMARY JUDGMENT

COWEN, *Chief Judge*, delivered the opinion of the court:

Plaintiff, successor by merger to Columbia Fuel Corporation, brought this suit for the refund of 1959 Federal income taxes in the amount of $170,819.84, or in the alternative amount of $107,341.65. During the taxable years 1949 through 1958, Columbian, herein referred to as the taxpayer, reported in its gross income the sum of $1,345,000, which it received from the sales of natural gas. The

entire $1,345,000 was included in the taxpayer's gross income for Federal income tax purposes during those years, because it appeared that the taxpayer had an unrestricted right thereto. In determining its taxable income for each of the years 1949 through 1958 inclusive, the taxpayer properly claimed and was allowed a 27½ percent depletion deduction with respect to the $1,345,000—a deduction of $369,875. During its taxable year ended December 31, 1959, the taxpayer, under threats of litigation, refunded the entire $1,345,000 to Panhandle Eastern Pipe Line Company and Colorado Interstate Gas Company. The repayment represented a refund of excessive rate charges made by the taxpayer on the sale of natural gas during the calendar years 1949 through 1958.

After refunding the overcharges, the taxpayer deducted the $1,345,000 on its 1959 income tax return, and this produced a net operating loss of $980,792.48 for that year. The taxpayer then filed a timely "Application for Tentative Carryback Adjustment" with respect to the net operating loss for each of its taxable years 1956 and 1958. The applications were allowed, and the taxpayer received refunds. However, upon examination of the return for the year 1959 and the carryback allowances, the Internal Revenue Service determined deficiencies which were assessed and paid on February 3, 1964. On April 3, 1964, the taxpayer filed a claim for refund for the overpayment of its income tax for 1959 in the amount of $688,945.91. The taxpayer claimed that the Internal Revenue Service had erred in failing to apply the provisions of Section 1341 of the Internal Revenue Code of 1954* in determining the

* Section 1341 of the 1954 Code provides:

"a) *General Rule.*—If—

"(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

Federal income tax consequences of the taxpayer's repayment of the $1,345,000. The Service agreed and, in applying Section 1341, determined that the lesser tax for 1959 was produced by computations made pursuant to Section 1341(a)(5). Several steps were then taken by the Service in its final determination on plaintiff's claim for refund. In computing the tax for the reopened prior years, the Service excluded the amounts the taxpayer collected during these years and repaid in 1959. However, the exclusions were reduced by the amount of the depletion deductions the taxpayer had been allowed during each of the prior years. The net effect of these transactions was the disallowance of the taxpayer's claim for refund for 1959 in the amount now sued for. Statutory notice of the disallowance was received on September 28, 1966, and thereafter plaintiff timely filed its petition in this case. The only issue to be decided is whether in the recomputation of its tax liability for 1959 under Section 1341 of the Code, the taxpayer was entitled to exclude the entire amount it repaid to its customers, as plaintiff contends, or whether

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"(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

"(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

"(4) the tax for the taxable year computed with such deduction; or

"(5) an amount equal to—

"(A) the tax for the taxable year computed without such deduction, minus

"(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years)."

the amounts to be excluded from gross income should be reduced by the depletion deductions allowed to the taxpayer during each of the years in question, as the defendant contends.

I

The issue here presented was decided adversely to the taxpayer by the Supreme Court in *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969), *reh. denied* 395 U.S. 941 (1969). The facts in that case are indistinguishable from those in the case at bar, except that there the parties stipulated that Section 1341(a)(5) did not apply and that the taxes should be computed under Section 1341(a)(4). In *Skelly*, the taxpayer, a natural gas producer, collected overcharges from its sales for a period of years, and these amounts were included in its gross income. There, as here, the taxpayer claimed in its tax returns for the prior years and was allowed a 27½ percent depletion deduction on the amounts of the overcharges that were later refunded to its customer. When the repayment was made in 1958, the taxpayer deducted the entire amount thereof on its 1958 tax return pursuant to Section 1341(a)(4), without any adjustment for the depletion deductions previously taken. The Supreme Court held that under Section 1341 of the Code, the deduction in the year of repayment must be reduced by the depletion allowance to the taxpayer in the year of receipt, since Congress did not intend to give taxpayers a deduction for refunding money that was not taxed when received. For the reasons hereinafter stated, we have concluded that adherence to the decision in *Skelly* requires the same result in this case and that plaintiff is not entitled to recover.

II

In an effort to avoid the effect of *Skelly*, plaintiff makes several contentions. The first is that the clear and unambiguous language of Section 1341(a)(5) provides "solely" for the exclusion of the amount repaid by the taxpayer in recomputing the tax for the prior year or years. Plaintiff

says that the word "item" in subsection (a)(5) is identical to the item referred to in subsection (a)(1) which, in this case, is $1,345,000. The defendant counters with the legislative history of Section 1341 and the regulation promulgated pursuant thereto. Before the enactment of Section 1341, if an item was included in income in a prior year under a claim of right and was repaid in a subsequent year, the taxpayer was entitled only to have his tax computed for the year of repayment with a deduction for the repayment. As the Supreme Court pointed out, Section 1341 of the 1954 Code was enacted to alleviate some of the inequities which Congress felt existed. Thus, subsections (a)(4) and (a)(5) provide alternative methods for computing the tax consequences when a taxpayer repays an amount previously received under a claim of right.

The legislative history of Section 1341(a)(5) includes the following declaration of the Congressional intent:

> In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected. [S. Rep. No. 1622, 83d Cong., 2d Sess., p. 452 (3 U.S.C. Cong. & Adm. News (1954) 4621, 5095); see also H. Rep. No. 1337, 83d Cong., 2d Sess., p. A294 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4437)].

Treas. Reg. § 1.1341-1(d)(4)(ii), which relates specifically to subsection (a)(5) provides:

> (4) *Computation of amount of decrease in tax.*
>
> • • •
>
> (ii) No item other than the exclusion of the income previously included under a claim of right shall be considered in computing the amount of decrease

> in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, *deductions for depletion* and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax. * * * (Emphasis supplied.)

Defendant asserts that this regulation expresses the intention of Congress that Section 1341(a)(5) should be interpreted to compensate the taxpayer adequately for the tax paid in a prior year or years but to avoid giving him a windfall. There is no doubt that if the regulation is valid, it fully supports defendant's position. Although the Supreme Court in *Skelly* did not deal specifically with the above-quoted regulation, the Court did say that the "item" referred to in Section 1341(a)(1) is the item included in the gross income in the year of receipt. The Court's opinion then went on to state the following:

> * * * The section does not imply in any way that the "deduction" and the "item" must necessarily be equal in amount. In fact, the use of the words "a deduction" and the placement of § 1341 in subchapter Q—the subchapter dealing largely with side effects of the annual accounting system—make it clear that it is necessary to refer to other portions of the Code to discover how much of a deduction is allowable. [394 U.S. 683].

Plaintiff argues that the regulation is invalid in that its reference to "deductions for depletion" is not mentioned in the legislative history and is an administrative attempt

to amend the statute. Plaintiff also says that the regulation is inconsistent with the Congressional intent in that the depletion deduction is dependent upon gross income from property, whereas Congress intended that the prior year adjustments should be restricted to those deductions which are dependent upon adjusted gross income, taxable income, or taxable net income. We need not explore in depth these arguments or those of the defendant as to the validity of the regulation. It is sufficient for our decision to conclude that the regulation is not inconsistent with with the statement from *Skelly*, quoted above, or with the whole rationale of the Court's opinion in that case.

Secondly, plaintiff maintains that under the provisions of Section 613 of the Code and the applicable regulations, the depletion allowance is dependent on "gross income from property" and that subsection (a)(5) speaks of a decrease in tax resulting only from "gross income." It follows, plaintiff says, that an adjustment for the depletion deduction is not allowable under Section 1341(a)(5). It is quite clear that, in *Skelly*, the Supreme Court was cognizant of the fact that the amount repaid by the taxpayer there had been included in its "gross income from property" from which depletion deductions had been taken. The Supreme Court's opinion stated that the amounts refunded by the taxpayer had been included in its gross income for the years 1952 through 1957 and that "The amount was also included in respondent's 'gross income from the property' as defined in § 613 of the Internal Revenue Code of 1954 * * *." [394 U.S. 679]. However, the Supreme Court attached no significance to the distinction plaintiff now urges. As we shall show, the Court's holding rested on other and broader grounds, and we are not persuaded that we should hold for plaintiff on a point which the Supreme Court was aware of but to which it gave no weight.

Plaintiff's third principal argument is that the *Skelly* case is not determinative of the issue here because that case involved Section 1341(a)(4), whereas the claim here is under Section 1341(a)(5). We do not agree. Our reading of *Skelly* leads to the conclusion that the Supreme Court would have reached the same result if Section 1341(a)(5) had applied in that case. In discussing the reasons for the enactment of Section 1341, the Court stated:

> • • • As an alternative to the deduction in the year of repayment which prior law allowed, § 1341(a)(5) permits certain taxpayers to recompute their taxes for the year of receipt. Whenever § 1341(a)(5) applies, taxes for the current year are to be reduced by the amount taxes were increased in the year or years of receipt because the disputed items were included in gross income. [Footnote omitted] [394 U.S. 682].

While the statement quoted above may be labeled as dictum, it is our opinion that the whole thrust of the decision in *Skelly* is contrary to each of the contentions made by plaintiff. The dominant and overriding basis of the Supreme Court's holding, with particular reference to the disputed adjustment for the depletion allowance involved in this case, is set forth in the following portions of the majority opinion:

> • • • In either case, the Code should not be interpreted to allow respondent "the practical equivalent of double deduction," *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 68 (1934), absent a clear declaration of intent by Congress. See *United States* v. *Ludey*, 274 U.S. 295 (1927). Accordingly, to avoid that result in this case, the deduction allowable in the year of repayment must be reduced by the per-

centage depletion allowance which respondent claimed and the Commissioner allowed in the years of receipt as a result of the inclusion of the later-refunded items in respondent's "gross income from the property" in those years. Any other approach would allow respondent a total of $1.27½ in deductions for every $1 refunded to its customers. [394 U.S. 684].

• • •

• • • In essence, oil and gas producers are taxed on only 72½% of their "gross income from the property" whenever they claim percentage depletion. The remainder of their oil and gas receipts is in reality tax exempt. We cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received. Cf. *O'Meara* v. *Commissioner,* 8 T.C. 622, 634–635 (1947). Accordingly, *Arrowsmith* teaches that the full amount of the repayment cannot, in the circumstances of this case, be allowed as a deduction.

This result does no violence to the annual accounting system. Here, as in *Arrowsmith,* the earlier returns are not being reopened. And no attempt is being made to require the tax savings from the deduction to equal the tax consequences of the receipts in prior years. In addition, the approach here adopted will affect only a few cases. The percentage depletion allowance is quite unusual; unlike most other deductions provided by the Code, it allows a fixed portion of gross income to go untaxed. As a result, the depletion allowance increases in years when disputed amounts are received under claim of right; there is no corresponding decrease in the allowance because of later deductions for

> repayments. Therefore, if a deduction for 100% of the repayments were allowed, every time money is received and later repaid the taxpayer would make a profit equivalent to the taxes on 27½% of the amount refunded. In other situations when the taxes on a receipt do not equal the tax benefits of a repayment, either the taxpayer or the Government may, depending on circumstances, be the beneficiary. Here, the taxpayer always wins and the Government always loses. We cannot believe that Congress would have intended such an inequitable result. [Footnotes omitted] [394 U.S. 685–686].

III

Alternatively, plaintiff claims entitlement to a refund of $107,341.65. This ground for recovery is based on Section 1341(a)(4). Plaintiff acknowledges that the taxpayer's claim in *Skelly* was also based on Section 1341(a)(4), and there is no doubt that a decision for plaintiff on this alternative ground would be in direct conflict with the decision of the Supreme Court.

IV

For the reasons stated, defendant's motion for summary judgment is granted, plaintiff's cross-motion for summary judgment is denied, and the petition is dismissed.

Treasury Regulations on Income Tax

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a

reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate.

* * *

(26 U.S.C. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * *

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) *General Rule.*—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

* * *

(b) *Special Rules.*—

(1) If the decrease in tax ascertained under subsection (a)(5)(B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

(2) Subsection (a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale of other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This paragraph shall not apply if the deduction arises out of refunds or repayments with respect to rates made by a

regulated public utility (as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof) if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation. This paragraph shall not apply if the deduction arises out of payments or repayments made pursuant to a price redetermination provision in a subcontract entered into before January 1, 1958, between persons other than those bearing the relationship set forth in Section 267(b), if the subcontract containing the price redetermination provision is subject to statutory renegotiation and Section 1481 (relating to mitigation of effect of renegotiation of Government contracts) does not apply to such payment or repayment solely because such payment or repayment is not paid or repaid to the United States or any agency thereof.

* * *

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.61-3. GROSS INCOME DERIVED FROM BUSINESS.

(a) *In general.* In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income, and without subtraction of selling expenses, losses, or other items not ordinarily used in computing cost of goods sold. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.

SEC. 1.62-1. ADJUSTED GROSS INCOME.

(a) The term "adjusted gross income" means the gross income computed under Section 61 minus such of

the deductions allowed by Chapter 1 of the Code as are specified in Section 62. Adjusted gross income is used as the basis for the determination of the following:

* * *

SEC. 1.613-3. GROSS INCOME FROM THE PROPERTY.

(a) *Oil and gas wells.* In the case of oil and gas wells, "gross income from the property", as used in Section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

SEC. 1.1341-1. RESTORATION OF AMOUNTS RECEIVED OR ACCRUED UNDER CLAIM OF RIGHT.

(a) *In general.*—

(1) If, during the taxable year, the taxpayer is entitled under other provisions of Chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by Chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

(2) For the purpose of this section "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and "restoration to another"

means a close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

* * *

(b) *Determination of tax.*—(1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under Section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under Section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax * * * for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. * * *

* * *

(d) *Determination of decrease in tax for prior taxable years.*—* * *

* * *

(4) *Computation of amount of decrease in tax.*

* * *

(ii) No item other than the exclusion of the income previously included under a claim of right shall be considered in computing the amount of decrease in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax. For the purpose of determining the

decrease in tax for the prior taxable year (or years) which would result from the exclusion from gross income of the item included under a claim of right, the exclusion of such item shall be given effect not only in the prior taxable year in which it was included in gross income but in all other prior taxable years * * * affected by the inclusion of the item (for example, prior taxable years affected by a net operating loss carryback or carryover or capital loss carryover).

* * *

Congressional Committee Reports

HOUSE REPORT No. 1337, 83D CONGRESS, 2D SESSION (1954), pp. 86, 87.

D. Claim of Right (Sec. 1341).

Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.

The committee's bill provides that if the amount restored exceeds $3,000, the taxpayer may recompute the tax for the prior year, excluding from income the amount repaid. This is an alternative to taking the deduction in the year of restitution. The $3,000 limitation is imposed for administrative reasons. Moreover, with smaller amounts, excluding the repaid amount from the earlier year's income is likely to have little, if any, tax advantage over taking a deduction in the year of restitution.

HOUSE REPORT No. 1337, 83D CONGRESS, 2D SESSION (1954), pp. A294, A295.

Part V—Claim of Right

Section 1341. Computation of tax where taxpayer restores substantial amount held under claim of right.

If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

In the case of a cash-basis taxpayer, in order to be entitled to a deduction in the later year, the amount must be repaid. However, in the case of an accrual-basis taxpayer, if the item was accrued but never received, the section applies when the deduction accrues in the later year although there is, of course, no amount to be repaid. Where an accrual-basis taxpayer has received the item, the time of accrual of the deduction again determines when the section comes into operation.

The section will not apply in the case of a bad debt. Even though a debt is uncollectible, the taxpayer does not lose his unrestricted right to the money. The section is specifically made inapplicable to sales of inventory, stock in trade, etc. An accrual basis taxpayer may instead estimate sales returns and guaranties in accordance with Section 462.

The section will apply to cases of transferee liability such as *Arrowsmith* v. *Commissioner* (344 U.S. 6 (1952)). Thus, while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because

his tax is reduced at least to the extent of the tax attributable to the prior inclusion.

In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected.

Whenever the decrease in tax for the prior year is greater than the tax for the taxable year (without the deduction attributable to the item in question), the excess is treated as a payment of tax on the last day prescribed by law for payment for the taxable year and will be refunded or credited as an overpayment for that year.

SENATE REPORT No. 1622, 83D CONGRESS, 2D SESSION (1954), p. 118.

D. Claim of Right (Sec. 1341).

(1) House changes accepted by committee.

Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.

The House and your committee's bill provide that if the amount restored exceeds $3,000, the taxpayer may recompute the tax for the prior year, excluding from income the amount repaid. This is an alternative to taking the deduction in the year of restitution. The $3,000 limitation is imposed for administrative reasons. Moreover, with amounts of $3,000 or under, the effect of excluding the re-

paid amount from the earlier year's income is likely to have little, if any, tax advantage over taking a deduction in the year of restitution. This section is inapplicable to refunds, allowances, bad debts, etc., pertaining to sales of inventory or stock in trade which may be provided for under Section 462 relating to reserves.

(2) Change made by committee.

Your committee's bill provides that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility where the refunds are required to be made by the regulatory body, such as the Federal Power Commission. It is made clear, for example, that refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section.

SENATE REPORT No. 1622, 83D CONGRESS, 2D SESSION (1954), pp. 451, 452.

PART V—CLAIM OF RIGHT

SECTION 1341. Computation of tax where taxpayer restores substantial amount held under claim of right.

Except for one revision this section corresponds to Section 1341 of the House bill.

If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case

(340 U.S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

In the case of a cash-basis taxpayer, in order to be entitled to a deduction in the later year, the amount must be repaid. However, in the case of an accrual-basis taxpayer, if the item was accrued but never received, the section applies when the deduction accrues in the later year although there is, of course, no amount to be repaid. Where an accrual-basis taxpayer has received the item, the time of accrual of the deduction again determines when the section comes into operation.

The section will not apply in the case of a bad debt. Even though a debt is uncollectible, the taxpayer does not lose his unrestricted right to the money. This section is specifically made inapplicable to sales of inventory, stock in trade, except refunds made by a regulated public utility in certain cases. An accrual-basis taxpayer may instead estimate sales returns and guaranties in accordance with Section 462.

Your committe has provided that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility (as defined in Sec. 1503(c)) if such refunds or repayments are required to be made by the Government, political subdivision, agency or instrumentality referred to in such section. Thus refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section.

The section will apply to cases of transferee liability such as *Arrowsmith* v. *Commissioner* (344 U.S. 6 (1952)). Thus, while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because his tax is reduced at least to the extent of the tax attributable to the prior inclusion.

In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other

items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected.

Whenever the decrease in tax for the prior year is greater than the tax for the taxable year (without the deduction attributable to the item in question), the excess is treated as a payment of tax on the last day prescribed by law for payment for the taxable year and will be refunded or credited as an overpayment for that year.

Brief for United States in Support of Its Motion For Summary Judgment (Pages 19-20)

The appropriate adjustment in this case eliminates the deduction for the depletion allowance attributable to the inclusion of the refunded item, thus, in effect, reducing the net taxable income for the prior year by 72½ percent of the refund. The result is to decrease the taxpayer's tax in the prior year by the tax on 72½ percent of the refunded amount, which is the very amount of tax paid on the entire overcharge in the year of receipt.[2]

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[2] In general, the computation is made in three steps: (1) the full amount of the item is excluded from gross income, (2) the dependent depletion deductions are eliminated, and (3) the tax on the resulting net income is then determined. Where, however, the item involved is depletable income, the depletion statute fixes the net taxable income in all cases. Hence, in such a case, the computation under Section 1341(a)(5) can be shortened by simply excluding 72½ percent of the item from gross income. Having the short cut in mind, the Government, in its answer here, admitted that the Commissioner of Internal Revenue in recomputing the tax for each of the prior years, determined net taxable income for each year by deducting the sum of the total amount of the overcharge reported less the depletion deduction allowed from the net taxable income reported in that year. * * *

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-592

CITIES SERVICE OIL COMPANY, SUCCESSOR BY MERGER TO COLUMBIAN FUEL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. App. 17-26) is reported at 462 F. 2d 1134.

JURISDICTION

The judgment of the Court of Claims was entered on July 14, 1972. (Pet. App. 17.) The petition for a writ of certiorari was filed on October 12, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

During the years 1949 through 1958, petitioner reported $1,345,000 in gross income from certain sales of natural gas, and, for tax purposes, deducted (and paid

no taxes on) 27½ percent of that amount as a depletion allowance. In 1959, petitioner refunded $1,345,000 to customers as overcharges attributable to the years 1949 through 1958. The question presented is whether under Section 1341(a)(5) of the Internal Revenue Code of 1954, which permits petitioner to reduce its 1959 income tax liability by the decrease in prior years' taxes which would result if the overcharges were excluded from the income reported for such years, the decrease in prior years' taxes attributable to the overcharges must be computed by including the savings in taxes attributable to the depletion deductions (27½ percent of the overcharges) taken by petitioner in those years.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 611, 613 and 1341 of the Internal Revenue Code of 1954 and Section 1.1341-1 of the Treasury Regulations on Income Tax (1954 Code) are set forth in the appendix to the petition at pp. 26-32.

STATEMENT

During the taxable years 1949 through 1958, petitioner,[1] a producer of natural gas, properly reported the amount of $1,345,000 in its gross income from certain sales of natural gas. In determining its taxable income for each of these years, petitioner claimed and was allowed a depletion deduction equal to 27½ percent of this amount, or $369,875. In 1959, under threats of

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[1] "Petitioner" refers to the Columbian Fuel Company, which was the taxpayer during the years in issue. This suit is brought by Cities Service Oil Company, successor by merger to Columbian.

litigation, petitioner refunded the entire $1,345,000, attributable to excessive rate charges made during the period 1949 through 1958, to two of its customers. (Pet. App. 17-18.) The correct treatment of this repayment on petitioner's 1959 income tax return is the subject of the instant suit.

Under Section 1341(a)(5) of the Internal Revenue Code of 1954 (Pet. App. 27-28), which is controlling, petitioner is entitled to reduce its 1959 income tax liability by an amount equal to the decrease in prior years' taxes which would result if the overcharges were excluded from petitioner's gross income for such years. Petitioner took the position that it was entitled to exclude the entire $1,345,000 from its prior years' income and to compute the resulting decrease in its taxes for those years without regard to the dependent 27½ percent depletion deduction taken and allowed. The Commissioner determined that the amount of taxes resulting from exclusion of the $1,345,000 from prior years' income should have been computed with reference to the depletion allowance. (Pet. App. 18-19.) Thus, the Commissioner's reduction of petitioner's 1959 income tax liability was equal to the taxes resulting from exclusion of the overcharges from prior years' income after deducting the 27½ percent depletion allowance—that is, the tax on 72½ percent of the overcharges, which was the actual tax petitioner paid when it included the overcharges in its prior years' income. On motions for summary judgment, the Court of Claims sustained the Commissioner's determination.

ARGUMENT

The decision below is correct and is consistent with

the rationale of this Court's opinion in *United States* v. *Skelly Oil Co.*, 394 U.S. 678. There is no conflict or other reason for further review.

1. The facts of this case are indistinguishable from those of *United States* v. *Skelly Oil Co.*, *supra*, where the taxpayer sought relief under Section 1341(a)(4) of the Internal Revenue Code. (Pet. App. 28.) That section allows a deduction from current income for the repayment of any amounts previously taken into income under the claim of right doctrine. In holding that the deduction in the year of repayment must be reduced by the percentage depletion deduction allowed when such amounts were taken into income, this Court noted (p. 685):

> In essence, oil and gas producers are taxed on only 72½% of their "gross income from the property" whenever they claim percentage depletion. The remainder of their oil and gas receipts is in reality tax exempt. We cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received.

Although the present case arises under Section 1341(a)(5) of the Code,[2] the *Skelly Oil* holding applies with equal force. Here, petitioner argues for a result which would entitle it to recover taxes on the 27½ percent of its "gross income from the property" which, as a result of the percentage depletion allowance, was

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[2] Section 1341 requires use of the subsection which will produce the "lesser" tax. In *Skelly Oil*, the computation under Section 1341(a)(4) produced this result. In the instant case, taxpayer realized a greater tax benefit by following Section 1341(a)(5).

originally tax exempt. The Court of Claims correctly determined that this Court's holding in *Skelly Oil Co.* would not permit such a result.

2. Section 1.1341-1(d)(4), Treasury Regulations on Income Tax (1954 Code) (Pet. App. 31-32), which is directly in point, is reasonable and consistent with the statutory provision, as well as with the legislative history. The regulation provides that in making the computation under Section 1341(a)(5), an appropriate adjustment must be made for any deduction in the prior years' income tax returns which was dependent upon "the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss)." Thus, under the regulation, petitioner was required to reduce the repaid amounts previously included in income by the 27½ percent depletion deduction in order to compute their tax effect in prior years. The Committee Reports, as well, while not specifically mentioning the depletion deduction, cite examples of deductions dependent upon adjusted gross income or taxable income, which must be accounted for to compute the true tax effect of inclusion of refunded amounts in prior years' income. See H. Rep. No. 1337, 83d Cong., 2d Sess., p. A294; S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 451-452.

Petitioner argues, however (Pet. 10-12), that the depletion deduction was not mentioned in the Committee Reports because it is not dependent upon the amount of adjusted gross income or taxable income, but, rather, relates to "gross income from the property." The regulation in question, however, accurately

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reflects the broader principle manifested by the Committee Reports—that, under Section 1341(a)(5), to compute properly the amount of taxes attributable to inclusion of the repaid items in prior years' income, allowance must be made for any correlative deductions. The approach petitioner suggests would give petitioner a tax refund on 100 percent of its repaid "gross income from the property" even though, as a result of the dependent depletion deduction, it paid taxes on only 72½ percent of that income when received. Accordingly, the court below properly sustained the validity of the regulation as a proper exercise of the Commissioner's authority. See *Bingler* v. *Johnson*, 394 U.S. 741.[5]

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[5] Petitioner contends that *Skelly Oil* should be reconsidered because the decision in that case relied upon a proposed Treasury Regulation which was not formally adopted. It is not clear why the proposed regulation cited in *Skelly Oil* was never adopted, but, in any event, the rationale of that regulation is embodied in Section 1.1341-1(d)(4) of the current Regulations, on which we rely here. Furthermore, the proposed regulation was only one of a number of factors which the court in *Skelly Oil* cited in support of its decision.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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